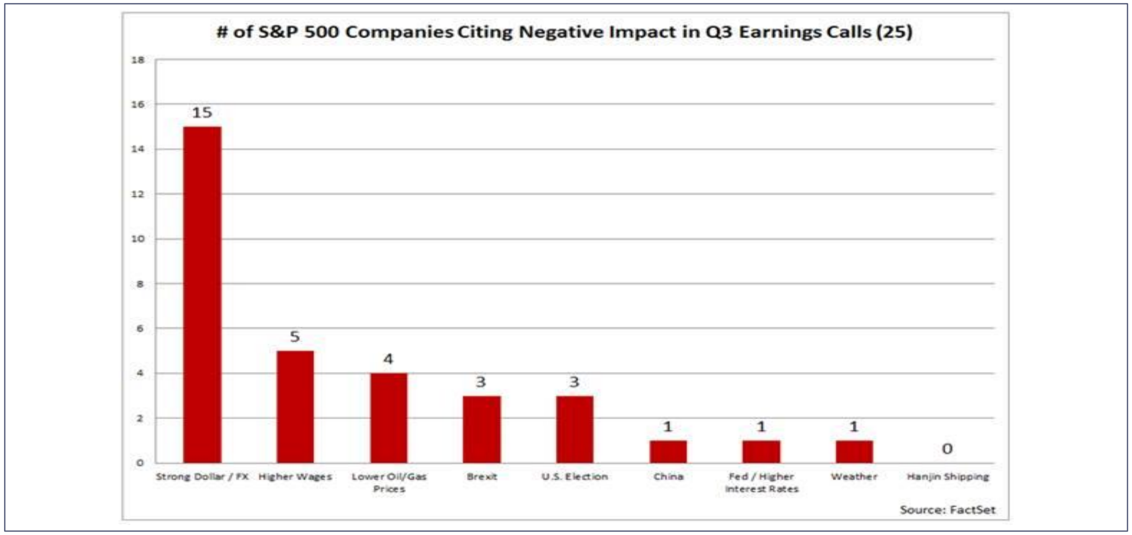
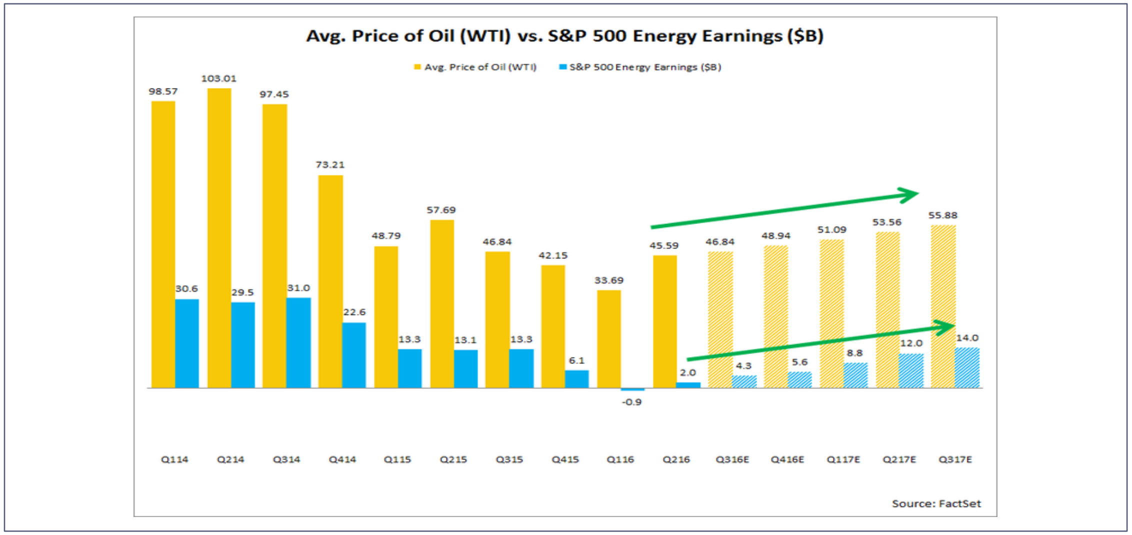
Market Recap

Wrestling With a Stronger Dollar



Source: Fact Set

Impact of Oil Prices on S&P Energy Sector Earnings



Source: Stifel

Earnings season is under way for the third quarter of 2016, and, if they are disappointing, it is certain that company management teams will come armed with a variety of explanations as to why business results failed to neatly follow plan. One powerful factor that stands out is the adverse impact of a stronger U.S. dollar on corporate profits. Of the 25 companies thus far that have cited adverse external impacts to their business in Q3, unanticipated currency swings are the #1 culprit. For large multinationals like Caterpillar, Microsoft, and Procter & Gamble (each of whom derive more than 50% of sales outside the U.S.), revenues from overseas operations take a haircut when converted back into stronger dollars. Even as investors continue to wait on the Fed to raise interest rates later this year, a rising dollar can have the same impact on markets – in fact, the dollar tends to rise faster before the Fed lifts rates than during the actual tightening cycle.

Much has been made of the significant price decline seen in the oil market over the past two years. This is no surprise, given the importance of oil prices as a key earnings driver for companies in the S&P 500 Energy sector. As we head into the 3rd Quarter earnings season, the Energy sector is projected to report the largest year-over-year decline (-66%) in earnings of all 11 sector groupings. This would mark the 8th consecutive quarter of y/y earnings declines for Energy companies. Looking forward, however, both oil prices and Energy sector profits are expected to increase over the next four quarters. If the price of oil were to rise from $46.84 in 3Q16 to $55.88 in 3Q17, earnings for the sector would increase from $4.3b to $14.0b. Needless to say, even a small improvement in energy prices would spur earnings growth for the sector, and give a needed boost to the market as a whole, given the sector's prominent role (9%) in the overall S&P.

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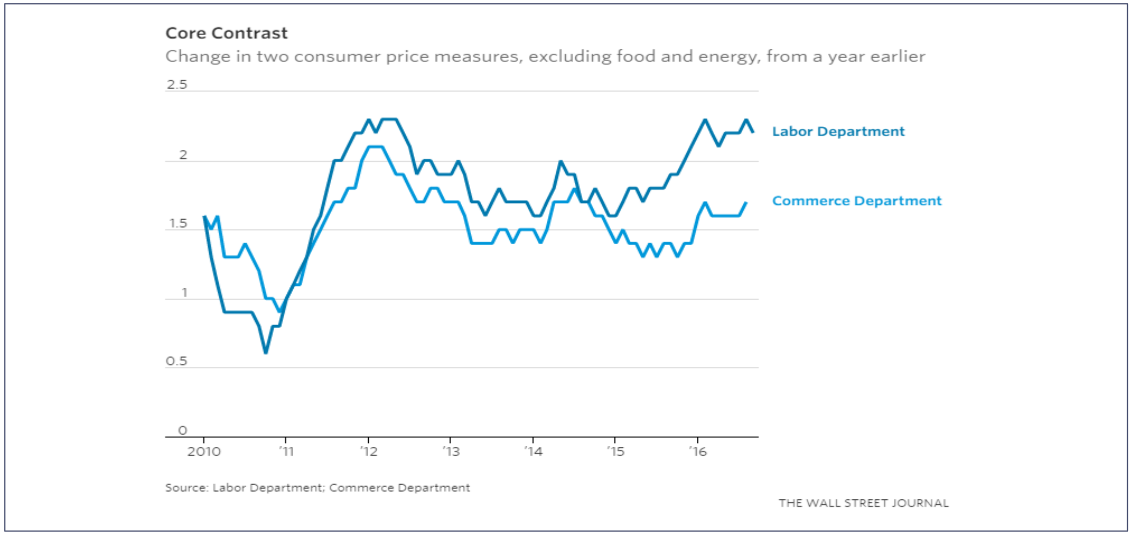
Signs of Rising Inflation



Source: JP Morgan

Inflation has begun picking up steam, putting additional pressure on the Fed ahead of its December meeting and rate hike decision. This week, the Labor Department reported that consumer prices rose 0.3% in September, leaving them a full 1.5% higher than 12 months prior. Core inflation has already been tracking at a higher level, coming in at 2.2% year-over-year. With gasoline prices stabilizing (y/y), annual inflation looks set to push the 2% boundary within a couple of months. Inflation is indicative of improving levels of economic activity, and the Fed has a stated 2% inflation target for driving its policy decisions. One caveat, however, is that the Federal Reserve uses a Commerce Department metric to track inflation that historically runs below the metric used by the Labor Department. Given this lower reading, the Fed may continue its restrained approach to rate hikes in order to allow the economy time to strengthen, either by delaying the rate hike process or embarking on a slower path of rate hikes than previously expected.

Holiday Retail Sales Outlook

Source: Bloomberg

The National Retail Federation has forecast a 3.6% rise in holiday spending (excluding gas, autos and restaurants), above the historical post-recession average increase of 3.4%. While the International Council of Shopping Centers has predicted a 3.3% increase, both forecasts came in well ahead of last year's realized holiday spending increase of 2.2%. Consumer spending has been a buffer to the economy this year as Americans have benefited from a combination of low inflation, rising wages, and historically high levels of employment. However, retail executives have cautioned that people seem to be shifting spending online and making fewer trips to stores. Another trend to watch has been the migration from goods accumulation to higher spending on experiences (travel, entertainment, food). These disruptions will affect the composition of retail spending going forward, and may cloud forecasters' ability to accurately predict their impact.

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